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CITATIONS

In the Supreme Court of the United States

OCTOBER TERM, 1949

No. 94

ERNEST A. JACKSON, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

No. 95

ROBERT O. FARRELL, DECEASED, HARRIS TRUST AND SAVINGS BANK, AS EXECUTOR, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR WRITS OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the Tax Court (R. 53-62) is reported at 9 T.C. 307. The opinion of the Court of Appeals (R. 90-95) is reported at 172 F. 2d 605.

JURISDICTION

The judgments of the Court of Appeals were entered on February 17, 1949 (R. 95-96). Peti-

tions for rehearing were filed on March 4, 1949, and were denied on March 16, 1949 (R. 96-98). A petition for writs of certiorari was filed on June 3, 1949. The jurisdiction of this Court is invoked under 28 U.S.C., Section 1254.

QUESTION PRESENTED

The underlying question in this case is whether a cash distribution by a corporation to the taxpayer-stockholders in 1941 was from the corporation's accumulated earnings and profits, and thus taxable as a dividend under Sections 22 (a) and 115 (a) of the Internal Revenue Code.

The answer to this question depends on whether a corporation, which incurred certain carrying charges in 1926 and 1927 to carry a building during its construction period when the property was unproductive, properly treated these expenditures as part of the cost of the building, as the court below held, or whether these expenditures should have been treated as current operating expenses when incurred, and charged to the earned surplus account, as the taxpayer-stockholders contend.

STATUTES AND REGULATIONS INVOLVED

The pertinent provisions of the statutes and regulations involved are set forth in the Appendix, *infra*, pp. 14-19.

STATEMENT

Substantially all the facts were stipulated (R. 28-52) and were found by the Tax Court as stipulated (R. 54).

The Wabash-Monroe Building Corporation (hereafter referred to as "the corporation") is an Illinois corporation organized August 28, 1925, to erect and operate a building at the corner of Wabash and Monroe Streets, Chicago, Illinois. It has engaged in no other business. On September 1, 1925, it acquired a 99-year lease covering the premises. After demolition of the buildings then standing, it commenced, in January, 1926, construction of a steel frame building, which was completed about June 30, 1927. (R. 54.)

During the construction period, the corporation had no income except interest on funds held to defray construction costs. During this period, it paid out the total amount of $383,805.55, which was charged on its books to building costs. The amount was composed of ground rentals of $115,000 due under the 99-year lease; net interest paid on bonds and notes of $149,261.59; state, real estate, and federal taxes of $86,258.54; and fees of $33,285.42 to disbursing agents and for financial services. (R. 54-55.)

These items were capitalized by the corporation because its accountants were of the view that good commercial accounting practice required that all expenditures should be capitalized during the construction period. Capitalization of the items accords with well-established accounting principles. (R. 55.)

The corporation carried the building on its books as of December 31, 1927, at a cost of $2,491,187.56,

which included the amount of $383,805.55, the 1926-1927 carrying charges, and excluded $14,720.27, the amount by which the building cost was reduced by a revenue agent who examined the corporation's 1927 tax return. This adjustment was accepted by the corporation. (R. 55.)

Depreciation on the building cost per books of $2,491,187.56 was claimed by and allowed to the corporation throughout the period July 1, 1927, to December 31, 1937. In 1938, the cost of the building per books was reduced to $2,486,774.80, as a result of correcting the net cost of a party wall, and from January 1, 1938, to November 30, 1941, depreciation was claimed and allowed to the corporation on this reduced cost. No other adjustments of the building cost, allowable as a basis for depreciation purposes, have been made by the corporation or by the Commissioner. (R. 55-56.)

On November 19, 1941, the corporation's directors declared a distribution to stockholders in the amount of $250,000 "on capital surplus." On November 30, 1941, a cash distribution in that amount was made to the stockholders and was charged on the corporation's books to "capital surplus." Taxpayer Jackson received $112,500 on the 450 shares of stock owned by him in 1941, and taxpayer Farrell received $125,000 on the 500 shares of stock owned by him in 1941 (R. 54, 56).[1]

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[1] Robert O. Farrell died after the hearing and submission of these cases to the Tax Court. The executor of his estate was

The full Tax Court, with no dissents, affirmed the Commissioner's contention that the corporation had properly added these carrying charges to capital account and that it was not required to treat them as expenses during the years when incurred (R. 57-62). This resulted in the sustaining of the deficiency determinations since the parties had stipulated that, if this were so, the corporation possessed sufficient earnings and profits so that the distributions to the taxpayers were taxable dividends (R. 37). The Court of Appeals affirmed the decision of the Tax Court (R. 90-95).

ARGUMENT

1. The decision below is correct. The charges which were incurred by the corporation on unproductive property during the period that improvements were being erected were part of the costs of the property and were not deductible expenses. This being so, the corporation possessed sufficient earnings and profits so that the distributions to the taxpayers qualified as taxable dividends (R. 36-37). Under Article 1561, Treasury Regulations 69 (Appendix, *infra,* pp. 16-17) there is no question but that carrying charges on unproductive property could properly be added to basis at a taxpayer's election. That is what the corporation here actually did and it claimed and was allowed deductions

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substituted as the petitioner in his stead in the Tax Court. (R. 53, fn.) Farrell will be referred to as one of the taxpayers in this brief.

for depreciation on such a basis for a period of fifteen years. It had the right to do so because the Treasury Regulations embody the correct interpretation of Section 202(b)(1) of the Revenue Act of 1926 (Appendix, *infra*, p. 14) which was in effect when these carrying charges were incurred. Those Regulations merely repeated the language of the House Committee Report on Section 202(b) of the 1924 Act, c. 234, 43 Stat. 253, where the statutory language first originated. H. Rep. No. 179, 68th Cong., 1st Sess., pp. 12-13 (1939-1 Cum. Bull. (Part 2) 241, 250). This, in itself, would be conclusive that the Regulations correctly expressed the legislative intent. The conclusion is buttressed by the additional fact that the language of Article 1561 was specifically adopted in statutory form beginning with Section 113 (b)(1)(A) of the Revenue Act of 1932, c. 209, 47 Stat. 169, being applicable to unimproved and unproductive real property, and was continued in all subsequent Acts and in the Internal Revenue Code. Section 130 (a) and (b) of the Revenue Act of 1942, c. 619, 56 Stat. 798, broadened Sections 24 (a) and 113 (b)(1)(A) of the Code so that a taxpayer now has an option to capitalize or to deduct such carrying charges on any kind of property. There being no evidence that a change in the existing law as to the right to capitalize carrying charges was contemplated by these steps, Congress could not have indicated more clearly its understanding that the prior Treasury Regulations had accurately re-

flected the congressional purpose. Cf. *Commissioner* v. *Wheeler,* 324 U.S. 542, 547. It seems undeniable that the court below was right in rejecting the taxpayers' contention that the corporation possessed no such election and that these provisions of the Regulations were invalid.

The court below also was correct in holding that the various items involved here were carrying charges on unproductive property which the corporation properly elected to charge to capital account under the Regulations. Article 1561 specifically lists "taxes" as one of the carrying charges which may be added to basis, and the real estate taxes (R. 55) which were here required to be paid while the property was still in an unproductive state were unquestionably within the category of expenditures which could be treated as part of the ultimate cost of the property. While the state and federal taxes on the corporation's bonds, and the state franchise tax (R. 55) are, perhaps, not taxes on the property itself, they were taxes required in connection with carrying the property until brought to a productive state, and were properly chargeable to capital account for that reason. The ground rental under the long-term lease, which the corporation was required to pay during the period in which the building was being constructed, was also the kind of carrying charge within the intent of the statute and the Regulations and, in any event, was properly chargeable to capital account since it was as necessary as any

of the construction costs to the completion of the building. Cf. G.C.M. 11197, XII-1 Cum. Bull. 238 (1933).

The interest on the construction fund (R. 54) which the corporation paid during the period of construction was also one of the costs of acquiring the completed building and could properly be added to basis. The cases cited by the taxpayers (Pet. 13), in an attempt to establish the contrary, are not in point. *Columbia Theatre Co.* v. *Commissioner,* 3 B.T.A. 622; *Spring Valley Water Co.* v. *Commissioner,* 5 B.T.A. 660; *Eastern Rolling Mill Co.* v. *Commissioner,* 5 B.T.A. 663; *Ottawa Park Realty Co.* v. *Commissioner,* 5 B.T.A. 474, and *Oswego & S. R. Co.* v. *Commissioner,* 29 F.2d 487 (C.A. 2d), affirming 9 B.T.A. 904, all involved years prior to 1924 when there was no provision of the statute or Regulations expressly permitting carrying charges to be capitalized, and the decisions there turned on the view that the statutory provisions for the deduction of interest precluded its capitalization. *Queensboro Corp.* v. *Commissioner,* 134 F. 2d 942 (C.A. 2d) (Pet. 13), recognized that when mortgage interest represented a "carrying charge" on unimproved lots, it could be capitalized under Section 113 (b)(1)(A) of the 1934 Act, c. 277, 48 Stat. 680. There, however, the mortgages were not used to acquire the property but were placed on the property after acquisition to raise money for other purposes, and the interest paid was correctly held not to be a capital item.

While the opinion in *Moran* v. *United States,* 19 F. Supp. 557 (C. Cls.) (Pet. 13), is not clear, it would seem likely that the situation there was similar to the *Queensboro* case.

Kentucky Natural Gas Corp. v. *Commissioner,* 47 B.T.A. 330 (Pet. 13), denied the taxpayer the right to capitalize interest charges, not because interest could never be added to capital account, but only because the property there was not unimproved and unproductive real property, and hence was not of the kind covered by the then provisions of the statute and Regulations. Had that not been so, the interest charges would have been permitted to be charged to capital account, as the Board indicated (pp. 340-341) and as the applicable Treasury Regulations expressly provided.

The other financing charges incurred here in connection with the construction loans (R. 55) come within the same category as interest on the loans themselves, and are essentially capital expenditures which may properly appear in the cost basis of the property.

The taxpayers' primary attack on the Regulations is premised on the assumption that, if valid, there would be an adverse effect on the revenue in other situations (Pet. 12-13, 14, 16, 17-18). Such solicitude seems strange when invoked as an argument by taxpayers who, as controlling stockholders and directors, caused the corporation to elect to treat these items as capital expenditures, filing

and signing for fifteen years the corporate income tax returns where depreciation was claimed and allowed on an augmented basis to the direct advantage of the corporation and to their indirect advantage as stockholders (R. 24-25, 34-35, 55-56). Their anxiety is not warranted, however, for Congress, which is the proper authority for establishing taxation policies, has consistently indicated its intention that taxpayers may elect to take the advantages first expressed in the Regulations and then specifically stated in the statutes.

2. Despite the fact that there may be a technical conflict in principle, the situation is not one requiring the intervention of this Court, and further review of this case would not be warranted. In *Central Real Estate Co.* v. *Commissioner,* 47 F. 2d 1036 (C.A. 5th), the court refused to permit a taxpayer to add interest and taxes to the basis of certain property where the taxpayer, by amended returns, had already claimed such items as deductions for prior tax years. Though it was unnecessary to its decision,[2] the court indicated that Article 1561, Treasury Regulations 69, was not a cor-

[2] The property was sold in 1924. Article 1561 of Treasury Regulations 65, promulgated under the 1924 Act, which was applicable in the *Central Real Estate* case, but which was not mentioned by the court, differed from Article 1561 of Treasury Regulations 69, which is involved here and which was the subject of comment in the *Central Real Estate* case, even though not applicable to the tax year in litigation. Regulations 65 did not grant the taxpayer the option which was given by Regulations 69, by subsequent Regulations, and by subsequent statutes, either to capitalize or to expense these items.

rect interpretation of the statute. In doing so, the court conceded that the explanation of Section 202 of the 1924 Act in the House Committee Report, *supra,* would have been persuasive that the Regulations were a proper interpretation of the statute. However, it felt bound to close its eyes to this evidence of congressional intent on the ground that Section 202 was too clear and unambiguous to permit of construction or to allow the use of legislative materials for ascertaining the correct meaning. More recent decisions of this Court demonstrate that the Fifth Circuit was wrong in deliberately ignoring, as irrelevant, such a clear expression by Congress of its intention. *United States* v. *Amer. Trucking Ass'ns,* 310 U.S. 534, 542-544; *United States* v. *Dickerson,* 310 U.S. 554, 561-562; *Harrison* v. *Northern Trust Co.,* 317 U.S. 476. If the *Central Real Estate* case were to arise today, the Fifth Circuit would undoubtedly follow the decisions of this Court respecting the use of legislative materials, and would be quick to recognize that the Commissioner's Regulations carried out the announced intention of Congress. Moreover, the *Central Real Estate* case was decided prior to the time that Congress specifically embodied the provisions of the Regulations in the statute, beginning with the Revenue Act of 1932. If the *Central Real Estate* case were to arise today, it is difficult to believe that the Fifth Circuit, with this added indication of congressional approval,

would still rule that the prior Regulations were at variance with the meaning of the statute.

Finally, since the basic matter has been governed by statute ever since 1932, it is evident that the question of the validity of the prior Regulations can arise only with respect to a limited number of situations. Accordingly, the existence of a conflict, even if it could be believed that the Fifth Circuit would still adhere to its former views, is not one requiring the exercise of this Court's authority.

There is no basis for asserting a conflict with other decisions, and the cases cited by the taxpayer (Pet. 10) are not opposed. *H.M.O. Lumber Co.* v. *United States*, 59 F. 2d 907 (C.A. 6th), similar to other cases already referred to, *supra*, p. 8, involved a taxable year prior to 1924. From what has already been stated about *Queensboro Corp.* v. *Commissioner*, 134 F. 2d 942 (C.A. 2d), and *Moran* v. *United States*, 19 F. Supp. 557 (C. Cls.), it is plain that those cases do not stand in conflict with the decision here. *F.H.E. Oil Co.* v. *Commissioner*, 147 F. 2d 1002, rehearing denied, 149 F. 2d 238, rehearing denied, 150 F. 2d 857 (C.A. 5th) (Pet. 10-11), does not merit discussion since it has nothing to do with the situation here or with the existence of a conflict.

CONCLUSION

The petition for writs of certiorari should be denied.

Respectfully submitted,

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JULY, 1949.

APPENDIX

Revenue Act of 1926, c. 27, 44 Stat. 9:

SEC. 202. (a) Except as hereinafter provided in this section, the gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the basis provided in subdivision (a) or (b) of section 204, and the loss shall be the excess of such basis over the amount realized.

(b) In computing the amount of gain or loss under subdivision (a)—

(1) Proper adjustment shall be made for any expenditure or item of loss properly chargeable to capital account, and

* * * * *

SEC. 212. * * *

(b) The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income. If the taxpayer's annual accounting period is other than a fiscal year as defined in section 200 or if the taxpayer has no annual accounting period or does not keep books, the net income shall be computed on the basis of the calendar year.

* * * * *

INTERNAL REVENUE CODE:

SEC. 115. DISTRIBUTION BY CORPORATIONS.

(a) *Definition of Dividend.*—The term "dividend" when used in this chapter (except in section 203(a)(3) and section 207 (c)(1), relating to insurance companies) means any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, or (2) out of the earnings or profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made.

(b) *Source of Distributions.*—For the purposes of this chapter every distribution is made out of earnings or profits to the extent thereof, and from the most recently accumulated earnings or profits. Any earnings or profits accumulated, or increase in value of property accrued, before March 1, 1913, may be distributed exempt from tax, after the earnings and profits accumulated after February 28, 1913, have been distributed, but any such tax-free distribution shall be applied against and reduce the adjusted basis of the stock provided in section 113.

*   *   *   *   *

(d) [As amended by Section 214 (b), Revenue Act of 1939, c. 247, 53 Stat. 862] *Other Distributions from Capital.*—If any distribution made by a corporation to its shareholders is not out of increase in value of property accrued before March 1, 1913, and is not a dividend, then the amount of

such distribution shall be applied against and reduce the adjusted basis of the stock provided in section 113, and if in excess of such basis, such excess shall be taxable in the same manner as a gain from the sale or exchange of property. This subsection shall not apply to a distribution in partial or complete liquidation or to a distribution which, under subsection (f) (1), is not treated as a dividend, whether or not otherwise a dividend.

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(26 U.S.C. 1946 ed., Sec. 115.)

Treasury Regulations 69, promulgated under the Revenue Act of 1926:

ART. 23. *Bases of computation.*—Approved standard methods of accounting will ordinarily be regarded as clearly reflecting income. A method of accounting will not, however, be regarded as clearly reflecting income unless all items of gross income and all deductions are treated with reasonable consistency. See section 200 for definitions of "paid or accrued" and "paid or incurred." All items of gross income shall be included in the gross income for the taxable year in which they are received by the taxpayer, and deductions taken accordingly, unless in order clearly to reflect income such amounts are to be properly accounted for as of a different period. (See sections 200 (d) and 213 (a).) * * *

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ART. 1561. *Determination of the amount of gain or loss.*—Section 202 sets forth the rules for the determination of the amount of gain or loss from the sale or other disposition of property. In general, the gain

from the sale or other disposition of property is the excess of the amount realized therefrom over the cost or other basis provided in section 204 and articles 1591-1603, and the loss is the excess of such cost or other basis over the amount realized. Whether gain or loss from a sale or exchange shall be recognized, and if so, the extent to which it is to be recognized for the purpose of income taxation must be determined under the provisions of section 203 and articles 1571-1580.

The amount realized from the sale or other disposition of property is the sum of any money received plus the fair market value of the property (other than money) received. In computing the amount of gain or loss, however, the cost or other basis of the property must be increased by the cost of capital improvements and betterments made to the property since the basic date, and by carrying charges, such as taxes on unproductive property. Where the taxpayer has elected to deduct carrying charges in computing net income, or used such charges in determining his liability for filing returns of income for prior years, the cost or other basis may not be increased by such items in computing the gain or loss from the subsequent sale of the property. The cost or other basis of the property must then be decreased by the amount of the deductions for exhaustion, wear and tear, obsolescence, amortization, and depletion which have since the acquisition of the property been allowable in respect of such property, whether or not such deductions were claimed by the taxpayer or formally allowed. * * *

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Treasury Regulations 103, promulgated under the Internal Revenue Code:

> SEC. 19.41-2. *Bases of computation and changes in accounting methods.*—Approved standard methods of accounting will ordinarily be regarded as clearly reflecting income. A method of accounting will not, however, be regarded as clearly reflecting income unless all items of gross income and all deductions are treated with reasonable consistency. See section 48 for definitions of "paid or accrued" and "paid or incurred." All items of gross income shall be included in the gross income for the taxable year in which they are received by the taxpayer, and deductions taken accordingly, unless in order clearly to reflect income such amounts are to be properly accounted for as of a different period. * * *
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> SEC. 19.115-3 [as amended by T.D. 5059, 1941-2 Cum. Bull. 125]. *Earnings or profits.*—In determining the amount of earnings or profits (whether of the taxable year, or accumulated since February 28, 1913, or accumulated prior to March 1, 1913) due consideration must be given to the facts, and, while mere bookkeeping entries increasing or decreasing surplus will not be conclusive, the amount of the earnings or profits in any case will be dependent upon the method of accounting properly employed in computing net income. For instance, a corporation keeping its books and filing its income tax returns under sections 41, 42, and 43 on the cash receipts and disbursements basis may not use the accrual basis in determining earnings and profits; a corporation computing income on the installment basis as provided in section 44 shall,

with respect to the installment transactions, compute earnings and profits on such basis; and an insurance company subject to taxation under section 204 shall exclude from earnings and profits that portion of any premium which is unearned under the provisions of section 204(b)(5) and which is segregated accordingly in the unearned premium reserve. Among the items entering into the computation of corporate earnings or profits for a particular period are all income exempted by statute, income not taxable by the Federal Government under the Constitution, as well as all items includible in gross income under section 22(a) or corresponding provisions of prior Revenue Acts. Gains and losses within the purview of section 112 or corresponding provisions of prior Revenue Acts are brought into the earnings and profits at the time and to the extent such gains and losses are recognized under that section.

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